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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC-02643-85

24 May 1985

MEMORANDUM FOR: Director of Central Intelligence

FROM: David B. Low
NIO for Economics

SUBJECT: Economic Issues and Initiatives

1. This memorandum summarizes the economic issues which I believe will be of paramount policy and intelligence concern over the coming year.

2. There are three ways you can increase your impact on the consideration of these issues:

- A. Consistent, informed presence (by you or your representative) at NSC, Economic Policy Council, and other fora downtown, supported by DDI and NIC research and publications.
- B. NIC Estimates
- C. Participation in or sponsorship of conferences and other external events/contacts.

3. Accordingly, attached are brief reviews of:

- A. The Changing Economic Environment
- B. The Driving Issues
- C. Estimative Reporting on the Issues
- D. Other Possible Initiatives

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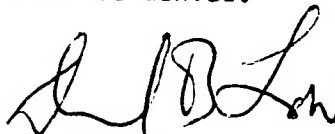
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4. By far, the most important method for you to make your presence felt in setting the agenda, and on the substance of economic issues with national security implications, is through consistent and forceful interest and involvement, directly (when the issue warrants) and through the NIO/Econ and other representatives and staff. This includes, of course, the wide range of DDI publications on economic issues with security implications.

5. The creation of the Economic Policy Council confronts us with a serious challenge to your ability to make your presence felt in this regard. You were notified only hours before the first EPC meeting, depriving us of time for proper preparation, and we were not even formally notified of the second meeting which took place yesterday. Also, on May 1 the Executive Secretary of the EPC sent a memo to members of the Council soliciting a list of domestic and international economic policy issues for consideration by the EPC. Weinberger, McFarlane, and you were not consulted. Secretary Baker and others must realize that CIA and the Intelligence Community have important contributions to make to the consideration of international economic issues, and that the national security community has a stake which must not be denied.



David B. Low

Attachments:
As stated

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DCI/NIC/NIO/Econ:DBLow:anw(24 May 85)

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Tab A

The Changing Environment

The domestic and international economic environment for U.S. policy will change significantly over the next one to two years. Owing in part to U.S. policy (and, in some measure, to good luck) economic trends in 1983/84 were largely favorable for U.S. interests.

- At home, rapid economic recovery was accompanied by a surge in productive investment, slowing inflation, and a strengthening dollar.
- Europe's recovery, while insufficient to stem growing unemployment, was accompanied by a shift to more conservative market-oriented economic policies and reduced inflation.
- The credit crisis eased in the LDCs as deep currency devaluations improved trade accounts and domestic growth resumed; here, too, there was a modest shift toward market policies, particularly in the agricultural sector.
- Economic growth revived in the Asian NICs, although there are signs of growing difficulties in Taiwan that may prevent it from continuing to compete with its Asian counterparts.
- In the defense area, Soviet economic growth continued below rates experienced by the West, while the NATO countries were able to sustain real increases in defense spending amid an atmosphere of greater unity in the face of the Soviet threat.

There were, of course, also many problems including the large U.S. trade deficit; industrial (and technological) stagnation in Europe; and continuing economic problems for those LDCs which rely heavily on tropical products and raw materials for exports, including many Latin American countries and the Philippines.

It is possible that several of these positive trends could turn against us or at least be less favorable over the next two years.

- U.S. economic growth will slow and could stall, investment in productive facilities will level off or decrease, and inflation will rise.

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- The failure of industrial recovery to take hold in Europe could bring problems for advocates of economic reform, particularly Margaret Thatcher and Helmut Kohl.
- There will likely be no additional increases in real defense spending among the NATO countries, including the U.S.
- And the IMF's efforts to use its funds as a lever for promoting economic reform in the LDCs may lose ground without the hoped-for transition to World Bank leadership in this area.

The political implications of these trends, should this scenario be accurate, include increasing political problems with European leaders and a dangerous economic challenge to the trend towards democracy in Central and South America.

Event-Driven Shifts in Interest

In addition to these changes in environment, several events have taken place over the last year that affect areas of future interest, including:

- China's dramatic move toward economic reform and accompanying requests for U.S. business and technological help.
- A less dramatic but, nevertheless, important move toward economic reform in India.
- The onset of what may be a gradual erosion in Soviet oil production and major decline in foreign exchange earnings.
- The arrival of Gorbachev in the face of these growing economic problems.
- A move toward protectionist pressures here and abroad accompanied by a call for new GATT negotiations to focus on key areas of U.S. concern including agriculture and services.
- An emerging effort to bring Europe up to speed in the technology area through the SDI.
- Failure of the British negotiations for Norwegian gas with implications for greater future European reliance on the U.S.S.R for energy.

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Tab B

The Driving Issues

1. LDC Economic Reform
 - China
 - India
 - Others, per your DCI White Paper of December 1984
2. Need for Industrial Country Structural Economic Reform
 - West European Malaise
 - Japanese Domestic Investment and Growth
3. Soviet Economic Trends
 - Gorbachev's Economic Strategy
 - Impact of Slow Growth
 - Erosion of Soviet Oil Production and Decline in Foreign Exchange Earnings
 - Trade with the U.S.
 - East European Tensions
4. West European Energy Dependence
5. Impact of Erosion/Fall in Oil Prices
6. LDC Debt
 - U.S. Strategic Interests in Key Countries
 - Role of IMF
7. Central American Economic Growth
 - Impact of Nicaraguan Economic Sanctions
8. Trade and the New GATT Round
 - Protectionism
 - LDC Role
 - U.S.-Japan Trade
9. Technology
 - Impact of SDI
 - Offshore Reliance

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Tab C

Estimative Reporting on the Issues

LDC Economic Reform: In China, the economic reform movement has so far followed largely predictable twists and turns. Rapid progress in some areas has been followed by crackdowns against "corruption" designed both to prevent excessive price increases and to co-opt critics on the left. The net result, nevertheless, has been impressive by any standards. Agricultural productivity has soared and displaced workers have gone on to increase output in other areas such as coal mining. Industrial output growth apparently topped 10 percent last year. Among other things, the Chinese are coming to us for digital equipment to set up a telephone network, and some rural areas, flush with funds and not content to wait, are actually bidding for cellular phone systems. There are now large queues of ships in several Chinese ports.

A National Intelligence Estimate is being developed on the prospects for success of reform. A second estimate is being considered that would review the implications of Chinese reform for other communist countries.

The DCI White Paper in December 1984 outlined a healthy shift toward economic reform in the non-communist LDCs. The lead sector for reform, as in China, is agriculture, and the NIC/AG is preparing a paper on the implications of this change.

Structural Reform: Little research has been done to date on the malaise in Western Europe that can be translated into positive policy action within the constraints seen by European governments. The problems with labor mobility, lack of entrepreneurial drive, etc., cannot be solved by sales of Volkswagen stock to the public, modest tax incentives, and an infusion of technology through the SDI.

NIC activity probably should focus on keeping abreast of work underway on structural adjustment and evaluating prospects for reform.

As to Japan, the structural problem of excessive domestic savings relative to investment continues to force the country into export markets and limits the potential for sales to the Japanese. Domestic growth not related to foreign sales is lagging. We have been and will continue to work with NSC, State, and others to put the current protectionist drive into a broader context of the need for structural change.

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Soviet Economic Trends: Despite the apparent ability of the Soviet Union to increase defense spending regardless of the performance of its overall economy, the shift in Soviet growth to rates below that of the West and prospects for continued problems absent major reform imply that the U.S.S.R. will be increasingly hard pressed to sustain its empire and a high level of arms growth. In addition, these economic problems may have already caused a shift in the flow of resources from the traditional pattern of Soviet support for Eastern Europe to Soviet reliance on Eastern Europe, portending possible difficulties for bilateral relationships as this shift becomes more apparent to members of the Bloc.

NIC monitoring, of course, should concentrate on Gorbachev's efforts to reverse these trends. Gross Soviet inefficiencies in the use of resources -- land, energy, capital goods, and labor -- make it possible for dramatic improvements should he be able to reform the bureaucratic system. Any successful reform would likely be the result of systemic changes with major implications for the Communist Party. To date, Gorbachev has taken the traditional approach -- replacing managers, a campaign against drunkenness, etc. -- all with predictable results. Nevertheless, we have to be watchful for significant efforts to reform the reward structure in areas such as agriculture and energy use -- areas which would produce significant benefits for Moscow if the bureaucracy can be convinced to loosen up. China's dramatic success with agricultural reform will give Gorbachev much ammunition; China's problems with inflation and control of resources will provide equally strong ammunition for his opponents.

In addition, we will monitor developments in Soviet foreign trade including the potential for the decline in oil earnings and efforts to acquire U.S. energy-related equipment.

West European Energy Dependence: The failure of the negotiations between the United Kingdom and Norway to develop Norwegian gas brings the issue of European gas policy and future dependence on the Soviet Union to the front burner. Work can be done (mostly through OGI) to evaluate the alternatives to Soviet gas including the possibility of injecting massive Norwegian gas resources into the major Dutch field to keep the Gronigen field producing at current rates into the next century.

The Possible Fall in Oil Prices: The administration's policy on oil prices has two competing goals: a) to allow market forces to determine prices and b) for strategic reasons, to sustain as long as possible the present situation of relatively low Western reliance on Persian Gulf oil. A SNIE is underway that will assess the political and economic impact of falling oil prices in terms of these goals.

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LDC Debt: NIC work to date has focused on the major debtor countries, by implication out of concern over the health of the international banking system. In fact, the debt crisis has affected our strategic interests in other areas.

- In the Philippines, economic problems are feeding growth of the communist insurgency.
- Debt-related crises have caused severe political problems in the Sudan and Jamaica, and problems can be seen growing in Egypt and Israel.
- Mexico is probably the major exception to this rule, as a large debtor of the highest importance to the U.S., with deteriorating political and economic conditions.

In the larger sense, the limitations of the IMF's ability to foster economic reform and the slow progress of AID's private sector initiative have contributed to these problems.

The implication for future NIC action is that we shift our effort away from tactical reporting on debt negotiations toward strategic reporting on the economic problems and possibilities for reform in those areas of major interest to the U.S., viz.: countries in Central America, the Philippines, Egypt, Israel, and Mexico.

Central America: There is an NSC meeting today on economic strategy for Central America. OALA and NIO/Econ helped develop the analytic section of the policy document that will be reviewed. The NIC and OALA will follow the impact of the economic program and will report on progress.

World Trade: The U.S. faces an uphill battle to get a meaningful round of GATT negotiations off the ground that will produce positive results for us in key areas of interest. Our threats to conduct bilateral and multilateral discussions with several areas, should the call for a GATT round fail, are being taken seriously. The package signed with Israel is a model for what can be accomplished with strong allies. Recently the Canadians are taking a more positive attitude on this score. NIO/Econ will hopefully be involved in the interagency councils leading up to the new round.

Technology: In an effort to integrate better research and the pace of progress, the U.S. has proposed joint research into the SDI. Success in this area would have broad implications for economic development.

While this issue is mainly monitored by NIO/S&T and others, the NIO/Econ can keep abreast of developments with the SDI. We should also be looking for areas where offshore reliance is growing in technologies of national security relevance. NIO/Econ is staying abreast of work by OGI and DOD on this issue.

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Tab D

Other Possible Initiatives

1. Stimulation of Private Sector Development in the Third World:

- As outlined in the DCI White Paper "Economic Forces for Change in the Third World" written under my auspices as NIO at Large, many Third World governments are beginning to initiate practical and market-oriented policies. The involvement of China and India is particularly significant, because over a third of the world's population is involved. This trend will, I believe, gain momentum over the next decade.
- This changing climate presents significant opportunities for the United States, but under present circumstances our ability to capitalize is limited. Aid is increasingly allocated for security assistance, and the entire U.S. AID structure is ill-equipped or -inclined to promote small-scale, entrepreneurial enterprises. At the same time, the commercial banks have little appetite for initiating voluntary lending for such development while wading through the next stage of the debt crisis.
- There are various ways in which you can demonstrate your concern/support for new thinking and approaches in this area:
 - A. I am involved in the preliminary planning for a White House-sponsored conference on this issue, to be held at Georgetown University. It would highlight some of the issues raised by the President's Task Force on International Private Enterprise, but would specifically focus on what U.S. Government and/or private sector mechanisms are required to stimulate effectively LDC private sector growth. At the appropriate moment, I will seek your support and involvement to influence the White House and others to take such a Conference seriously.
 - B. In the same vein, I propose to review informally with corporate officers and business organizations what would constitute the minimum political, economic and financial criteria in the Third World which would induce their participation in private sector development. Your suggestions of people for me to contact would be welcome.

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3. NIO/Economics can initiate in your name a conference or two on current economic topics, such as:

- Mexican Economic and Business Prospects
- Implications of Pacific Basin Economic/Business Growth
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Your scheduled presence and opening statement on June 3, 1985, at the conference sponsored by OGI on the "Economic and Security Implications of Structural Change" is a perfect example.

4. Your speeches before business and other groups could include selected economic issues.